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REPORT

Chinese Corporate Governance

History and Institutional Framework

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This report results from the RAND Corporation's continuing program of self-initiated research. Support for such research is provided, in part, by the generosity of RAND's donors and by the fees earned on client-funded research. This research was conducted within the RAND Center for Corporate Ethics and Governance, which is part of the RAND Institute for Civil Justice, a unit of the RAND Corporation.

Library of Congress Cataloging-in-Publication Data

Kang, Yong, 1975-
Chinese corporate governance : history and institutional framework / Yong Kang, Lu Shi, Elizabeth D. Brown.
p. cm.
Includes bibliographical references.
ISBN 978-0-8330-4611-6 (pbk. : alk. paper)
1. Corporate governance—China. I. Shi, Lu. II. Brown, Elizabeth D., 1970– III. Title.

HD2741.K36 2008
338.60951—dc22

2008045339

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Published 2008 by the RAND Corporation
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Summary

Introduction

Since China started its economic reform in the late 1970s, its gross domestic product has been growing at an average annual rate of 9.73 percent. Chinese stock markets have also been growing rapidly, especially since late 2005, when share merger reform started. Today, there are more than 1,500 publicly traded Chinese companies, and the total market capitalization surpassed 24.5 trillion renminbi (RMB) in August 2007.

Despite this rapid growth, corporate governance has been very weak in China. In a survey by the World Economic Forum, China ranked 44 out of 49 studied countries in terms of corporate governance (Liu, 2006). Corporate governance is critically important to a country's economic growth and stability, because it provides the credibility and confidence in management that is fundamental to capital markets.

To date, research on Chinese corporate governance has been sparse. This report begins to address this gap by providing a basic overview of the status of corporate governance mechanisms in China.

Development of Corporate Governance in China

The historical development of corporate governance in China has gone through four stages. In the first stage, from 1949 to 1983, state-owned enterprises (SOEs) dominated the Chinese economy, and the state commanded and controlled almost every aspect of the economy. Western-style corporate governance did not exist in China.

The second stage, from 1984 to 1993, involved the beginning of the separation of government and enterprise in China. During this period, China formally established the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE), and a new government body, the China Securities Regulatory Commission (CSRC), was created to be the country's main regulator of the newborn stock market.

The third stage, from 1994 to 2005, marked the beginning of experimentation in modern enterprise structure, including passage of the first Company Law—the first comprehensive law that fully delineated the rights and responsibilities for modern companies in China. Although the Company Law has had a far-reaching impact on corporate governance and the economy as a whole in China, state shareholders still enjoyed overwhelming favoritism over individual investors.

The final stage, from 2006 onward, has witnessed the continuing growth of corporate governance in China, including legislation aimed at balancing the power asymmetry between state shareholders and individual shareholders in companies.

The Institutional Framework

Many entities both inside and outside companies play a role in shaping the behavior and governance of Chinese companies. The inner circle of oversight consists of shareholders' general meetings, boards, and management personnel who are engaged in operating the companies and are directly responsible for their governance. The outer circle is composed of regulators (chiefly, the CSRC), stock exchanges (the SSE and SZSE), the Chinese legal system, the auditing system, and institutional investors. These players have a significant impact on companies' corporate governance, but they mainly do this through regulation, codes of conduct, certification of financial reports, and legal enforcement. Besides these institutional pillars, there are other agents who may also affect corporate governance (e.g., consumers, suppliers, employees, media, and nongovernmental organizations).

Problems of Corporate Governance in China

Despite recent reforms made in corporate governance controls and institutions in China, a number of problems still remain. First, there is **concentration of state ownership.** Approximately two-thirds of companies listed in the SSE are state enterprises, which leads to inefficiency in capital allocation, whether it comes directly from a government body or through a brokerage firm.

Second, a direct result of ownership concentration is the **lack of independence among board directors**. Given the overwhelming governmental dominance of Chinese boards of directors, the supervisory board in China has not yet played a significant and effective governance role.

Third, **insider trading** is a very serious problem among China's listed companies. Reasons for this include the lack of a well-defined concept for fiduciary duty, inefficient enforcement of securities laws, the absence of class actions in China, and the lack of any incentive mechanism to encourage reporting or whistle-blowing about insider trading.

Fourth, **false financial disclosures** by companies remain a significant problem. According to a random check by the Ministry of Finance, a significant number of Chinese companies forged their earnings in annual reports in 2001.

Finally, China continues to suffer from **immature capital markets**, characterized by the Chinese banks' preferential treatment of SOEs, difficulties in issuing corporate bonds, and the absence of preferred shares as a financing/investment option.

Conclusion

China has made rapid progress in corporate governance, in part because of the gradual removal of ownership and personnel barriers, coupled with an increasingly globalized and mature business environment. However, despite this rapid progress, serious problems abound in various aspects of Chinese corporate governance, ranging from company ownership structures to the media environment in which Chinese companies and security markets operate.

Several options have been proposed to deal with these problems, including more clearly defining the functions of the supervisory boards, making it easier for whistleblowers to sue management, toughening legal obligations for managers involved in insider trading, lowering the minimum required number of shares for shareholders to raise proposals, increasing the legal obligation of controlling shareholders, and developing a long-term focus incentive compensation system for directors and executives (e.g., long-term nontradable options).

In addition, we propose reviving and institutionalizing the once-banned, regional, over-the-counter markets, because doing so would offer an opportunity to improve the corporate governance of Chinese enterprises, while providing a buffer zone for companies facing the risk of delisting in the stock exchanges. Similarly, accelerating the development of the corporate debt market could help meet the needs of the more risk-averse investors and, thereby, increase the capital supply for Chinese companies in need of steady capital input. Finally, we suggest establishing an incentive mechanism to encourage the reporting of insider trading. Increasing the organizational performance of the CSRC and stock exchanges and promulgating the concept of fiduciary duty will take a considerable amount of time and cost. By contrast, providing incentives for exposing insider trading would likely cost less and could be more effective as a governance mechanism in China than in the United States.